FOREIGN MILITARY SALES

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DIRECT COMMERCIAL SALES

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INTRODUCTION

International military sales are on the rise. While the United States and European Union are cutting their defense expenditures, several countries—particularly in East Asia, South Asia, the Middle East, and South America—are increasing expenditures. Hence, U.S. Contractors are increasingly seeking to sell products and services to these markets. There are two primary methods for doing so: government-to-government sales through the U.S. Government's Foreign Military Sales ("**FMS**") program and similar mechanisms, and Direct Commercial Sales ("**DCS**") negotiated directly between the contractor and the foreign customer. Both methods have existed for decades, but a novice to international sales has a steep learning curve regarding the complexities of each.

Just how big is this market? From 2003 to 2006, government-to-government sales administered by the U.S. Defense Security Cooperation Agency ("**DSCA**"), of which FMS sales are greatest part, were approximately $10-$12 billion per year; since 2006, however, annual sales have repeatedly exceeded $21 billion, hitting $69 billion in 2012. And available data indicates that DCS sales are even greater. In 2005, the value of DCS deliveries eclipsed that of FMS deliveries by nearly a 3:1 margin.[1] From 2005 to 2009, DCS is estimated to have accounted for almost 60% of exported U.S. military articles—almost $60 billion out of $101 billion.[2] Of this total, DCS was responsible for roughly 66% (*i.e.*, $17 billion) of aircraft equipment and parts exports; roughly 80% (*i.e.*, $15 billion) of satellites, communications and electronic equipment, and parts exports; and roughly 40% (*i.e.*, $7 billion) of aircraft exports.[3]

Of course, whether U.S. Contractors will retain their market share of international sales is another question. Foreign defense firms have become significant competitors for the U.S. defense establishment.[4] This competition makes it even more important for U.S. Contractors to understand and actively navigate the rules governing FMS and DCS—alternatives that are complementary, not rivals, but that have unique attributes.

Accordingly, two threshold considerations for a foreign country Purchaser or U.S. Contractor contemplating an international purchase/sale are (a) which option is available for a particular sale, whether FMS or DCS (or both); and (b) the advantages and disadvantages of each option. As discussed below, FMS offers a "total package" approach that appeals to many Purchasers; alternatively, for eligible defense articles and services, savvy U.S. Contractors and Non-U.S. Purchasers might find greater flexibility in DCS to structure, negotiate, and execute contract terms that are tailored to their respective needs and goals. A decision as to whether to pursue FMS, DCS, or a combination of both, will likely depend upon the unique circumstances of each transaction, as well as the risks and challenges created by a complicated patchwork of relevant U.S., foreign, and international laws.

This paper is divided into three sections. The first section, authored by Derek Gilman, the General Counsel of DSCA, presents an overview of the FMS process and legal issues relevant to FMS. The second section, authored by the Government Contracts practice group at the law firm Covington & Burling LLP, discusses the DCS process and legal issues relevant to DCS. The final section summarizes some of the considerations that Purchasers and U.S. Contractors may consider when choosing between FMS and DCS.

FOREIGN MILITARY SALES[5]

I. AN OVERVIEW OF FMS

The Foreign Military Sales (as defined above, "**FMS**") program has been a key component of U.S. foreign policy and national security for the last several decades. In recent years, it has taken on increased importance, as the United States has sought to build the capabilities of foreign partners to participate in counter-terrorist operations, and in operations in Afghanistan and Iraq. Further, the enactment of various "building partner capacity" authorities has resulted in increased reliance on the FMS process to implement so-called "FMS pseudo cases." As noted above, sales by the U.S. Department of Defense ("**DoD**") have increased substantially over the past decade.

The FMS program exists, not necessarily for the purpose of providing a market for U.S. Contractors, but for the purpose of building relationships with foreign countries. This overriding purpose is codified into the statute governing the FMS program, the Arms Export Control Act ("**AECA**"),[6] which provides:

> Accordingly, it remains the policy of the United States to facilitate the common defense by entering into international arrangements with friendly countries which further the objective of applying agreed resources of each country to programs and projects of cooperative exchange of data, research, development, production, procurement, and logistics support to achieve specific national defense requirements and objectives of mutual concern. To this end, this chapter authorizes sales by the United States Government to friendly countries having sufficient wealth to maintain and equip their own military forces at adequate strength, or to assume progressively larger shares of the costs thereof, without undue burden to their economies, in accordance with the restraints and control measures specified herein and in furtherance of the security objectives of the United States and of the purposes and principles of the United Nations Charter.

A. FMS Legal Authorities

The specific authorities permitting DoD to sell defense articles[7] and services[8] to foreign countries and international organizations are in section 21 and 22 of the AECA.[9] Section 21 of the AECA authorizes the President to sell defense articles and services from the stocks of the DoD. This authority is often described as an authority to sell excess defense articles (Section 516 of the Foreign Assistance Act[10] provides an authority to grant excess defense articles to foreign countries). Section 22 of the AECA provides the President with authority to enter into contracts for the procurement of defense articles or services for sale for U.S. dollars to eligible foreign countries and international organizations. These authorities have been delegated to the Director of the Defense Security Cooperation Agency (as defined above, "**DSCA**").[11]

Of course, DSCA does not exercise these authorities in isolation. Pursuant to section 2 of the AECA, the U.S. Department of State must approve sales of defense articles and services to foreign countries.[12] Furthermore, prior to the initial export to a country or international organization, the President must determine that the foreign country is eligible to receive exports of defense articles and services under the AECA.[13]

Sanctions and export control laws also come into play. The recipient country must be eligible for exports at the time of the proposed export. Sanctions may be imposed under a variety of laws that prohibit exports for a range of reasons, including trafficking in persons and failure to make timely payments on debts owed the United States. In addition to the country being eligible to receive exports, the defense article or defense service must also be approved for export; in that regard, the U.S. Government must determine that the technology can be exported to the country in question.

B. <u>The FMS Letter of Offer and Acceptance</u>

Foreign countries wishing to purchase defense articles and services through FMS must first provide a "Letter of Request," or "**LOR**."[14] There is no required form for the LOR, and it may take the form of a letter, request for proposal, or other written format containing sufficient information to provide a response.[15] Thus, the LOR can be issued as a sole source request, a single supplier request, or as part of a competition. Depending upon the request in the LOR, the response may be Pricing and Availability ("**P&A**") information or a Letter of Offer and Acceptance ("**LOA**").

An LOA is a government-to-government agreement governed by U.S. law. It is signed by representatives of the DoD and the foreign government.[16] Each LOA contains a set of Standard Terms and Conditions that provide the U.S. Government and foreign country obligations, as well as the general financial terms of the transaction.[17] Of note, the LOA Standard Terms and Conditions provide that the foreign country agrees that it will only use the defense articles or services for purposes of legitimate self-defense, internal security, and other purposes allowed under section 4 of the AECA.[18] Additionally, the Standard Terms and Conditions provide that the foreign country agrees to allow the U.S. Government to conduct end use monitoring inspections, to not transfer title or possession without the consent of the U.S. Government, to maintain security for the defense articles equivalent to what the United States would provide, and to pay the total cost for the defense articles and services, even if the cost exceeds the price listed in the LOA.[19] It is important to note that the price in the LOA is an estimate. Under U.S. law, the price listed in the LOA cannot be a not-to-exceed price, as an increase in cost not paid for by the foreign country would be an unfunded obligation of the U.S. Government that is not authorized by law.

Additionally, the foreign country, recognizing that the U.S. Government will procure and furnish the defense articles and services described in this LOA on a non-profit basis, must agree to indemnify and hold the U.S. Government, its agents, officers, and employees harmless from any and all loss or liability (whether in tort or in contract) which might arise in connection with the LOA because of injury to or death of personnel of the foreign country or third parties; damage to or destruction of (a) property of DoD furnished to the foreign country or to contractors specifically to implement this LOA; (b) property of the foreign country (including the items it ordered pursuant to the LOA, before or after passage of title); or (3) property of third parties, or; infringement of intellectual property rights. Further, the foreign country must agree to relieve the contractors and subcontractors of the U.S. Government from liability for, and will assume the risk of, loss or damage to: the foreign country's property (including items procured pursuant to the LOA, before or after passage of title; and property of DoD furnished to contractors to implement the LOA, to the same extent that the U.S. Government would assume for its property if it were procuring for itself the items being procured.[20] The U.S. Government will endeavor to procure warranties for the foreign country, if requested. The cost of any such warranties would be included in the LOA price.

In an FMS case, title is normally transferred to the purchaser (*i.e.*, the foreign country or international organization) at the initial point of shipment, unless otherwise specified in the LOA. In the case of items procured for sale, title normally passes at the manufacturer's loading facility, while in the case of items furnished from DoD stocks, title normally passes at the U.S. depot.[21]

C. <u>Foreign Military Financing for Purchases</u>

Funding for FMS purchases is generally provided by the foreign country. However, for certain countries, funds are appropriated by Congress for Foreign Military Financing ("**FMF**").[22] By law, Israel and Egypt receive most of the FMF-appropriated funds.[23] Other countries receive smaller amounts, based upon a justification provided to Congress by the U.S. Department of State. Section 23 of the AECA provides authority to finance the procurement of defense articles and services by friendly foreign countries through credit sales. However, in recent years, the legislation appropriating FMF has stipulated that it is provided on a non-repayable basis (i.e., FMF is now provided as a grant and not a loan).[24] Furthermore, the appropriations language states that the funds are "obligated upon apportionment"[25]; the effect of this language is that the funds do not expire at the end of the fiscal year are available for expenditure in future years so long as they have been apportioned, even if they have not yet been obligated.

Certain countries have been approved to use FMF to make direct commercial sales purchases. These purchases, known as "direct commercial contracts" (a "**DCC**"),[26] are discussed in more detail in the next section of this paper. DSCA approves DCCs on a case-by-case basis pursuant to a set of guidelines published on the DSCA website.[27]

D. <u>Other Financial Issues</u>

The general rule for payment for an FMS case is that payment is due upon signing.[28] However, payment may be made at a later time if a country is able to give a "dependable undertaking" to pay the full amount of the contract and to make funds available in such amounts and at such times as may be required by the contract. The time of payment for countries that are able to give a dependable undertaking will be a matter of negotiation, but generally, the payment due date will not be delayed beyond the delivery date, although there are rare exceptions.[29] Whether the terms of sale of an FMS LOA will be able to include a dependable undertaking will depend upon the country's Interagency Country Risk Assessment System ("**ICRAS**") rating. If a country does not have an ICRAS rating, DSCA may determine eligibility using the DSCA Dependable Undertaking Assessment Tool. In general, a country with an ICRAS rating of "C" or better at the time of receipt of the LOR is presumed to be eligible to have the term of sale for dependable undertaking included in its FMS LOA, unless other factors override that eligibility determination.[30]

In general, purchasing countries pay with their national funds, unless they have been allocated, and are using, FMF. However, it is possible that a third source could provide funding to the purchasing country, which the purchasing country could use to pay for its FMS case. The AECA provides that purchases using FMS must be in U.S. dollars, regardless of the source of the payment.[31]

The FMS program does not receive appropriations (although some countries are receive an allocation of FMF), and therefore must be managed at no cost to the U.S. Government. Hence, the LOA mandates that the purchaser pay the full program cost. The LOA will be modified or amended from time-to-time as necessary to reflect changes to the FMS case.

The FMS Trust Fund is used for receiving payments from purchasing countries and international organizations and for making disbursements against implemented FMS cases. This fund is cited directly on contracts for the procurement of defense articles and services, and is used to reimburse DoD Components for sales from DoD stocks or services performed by DoD employees. DSCA manages the FMS Trust Fund managed in accordance with the DoD Financial Management Regulation ("**FMR**") and guidance from the Office of Management and Budget ("**OMB**").[32]

Certain countries have been approved to use FMF to make direct commercial sales purchases. These purchases are known as "direct commercial contracts" ("**DCCs**").[33] DSCA approves DCCs on a case-by-case basis pursuant to a set of guidelines published on the DSCA website.[34]Termination liability ("**TL**") reserves generally must be maintained in the purchaser's FMS Trust Fund account. TL is the potential cost for which the U.S. Government would be liable if an FMS case is terminated prior to completion.[35] If approved by DSCA a standby letter of credit may be used instead of, or to reduce, termination liability to guarantee termination payments.[36]

Some countries may establish an account with the Federal Reserve Bank of New York ("**FRB NY**") for their FMS deposits. For this to occur, the foreign country's defense organization, its central bank (or acceptable equivalent), FRB NY and DSCA must enter into an agreement setting forth the terms, conditions, and procedures for the operation of the account.[37]

Other countries may establish an account with a commercial bank for their FMS deposits. For this to occur, two agreements are required: an agreement between the foreign country and the participating commercial bank, and a separate agreement between the foreign country and DSCA.[38]

E. <u>Nonrecurring Costs</u>

Certain nonrecurring costs of research, development, and production must be recovered on FMS sales unless they are waived. Section 21(e)(1) of the AECA provides that LOAs shall include charges for a proportionate amount of nonrecurring costs of research, development, and production of major defense equipment.[39] Major defense equipment is defined as any item of significant military equipment on the United States Munitions List ("**USML**") having a nonrecurring research and development cost of more than $50,000,000 or a total production cost of more than $200,000,000.[40] Significant military equipment is identified in the USML with an asterisk. Nonrecurring costs may be waived if the sale would significantly advance U.S. Government interests in standardization with NATO, Japanese, Australian, South Korean, Israeli, or New Zealand forces.[41] Additionally, charges may be waived if the Director, DSCA determines that imposition of the charges likely would result in loss of the sale or if he determines that in the case of a sale of major defense equipment that is also being procured for the use of the U.S. Armed Forces, waiver of the charges would (through a resulting increase in the quantity of the equipment purchased that causes a reduction in the unit cost) result in a savings to the United States that substantially offsets the revenue foregone as a result of the waiver.[42] Detailed rules regarding nonrecurring costs are provided in the Code of Federal Regulations and in the DoD Financial Management Regulation.[43]

It should be noted that in certain cases a foreign country may have incurred nonrecurring costs in the development of a defense article, or of a specific version of a defense article. In such cases, if the costs qualify as recoverable nonrecurring costs and the foreign country's nonrecurring cost investment exceeds $50 million, then the United States will collect the nonrecurring cost recoupment for the foreign country. Such recoupment cannot be waived.

II. OTHER PROGRAMS ASSOCIATED WITH FMS

A. Other Security Assistance Programs – Leases and Excess Defense Articles

DoD may lease defense articles from its stocks to eligible foreign countries or international organizations. In general, the period of the lease may not exceed 5 years.[44] There must be compelling foreign policy and national security reasons for providing such articles on a lease basis, and the articles must not be needed for public use at the time. The effects of the lease on the national technology and industrial base must be considered, particularly the extent, if any, to which the lease reduces the opportunity of U.S. manufacturers to sell new equipment to the lessee.[45]

DoD and U.S. Coast Guard may provide excess defense articles ("**EDA**") to eligible foreign countries or international organizations on a sale or grant basis. EDA are offered on an "as is, where is" basis. In order to be eligible to receive grant EDA, foreign countries must have agreed to blanket end-use, security, and retransfer assurances. These assurances track the verbiage of section 505 of the Foreign Assistance Act and are generally made in the form of an exchange of diplomatic notes.[46] Sales of EDA are pursuant to the authority provided by section 21 of the AECA. The FMS LOA for such EDA sales contains similar assurances, as explained earlier in this article. Pricing of EDA items to be sold is in accordance with DoD FMR.[47]

B. Building Partner Capacity Programs

In contrast to FMF and the FMS program are the various "Building Partner Capacity" ("**BPC**") programs. These programs authorized under a number of different authorities and are funded with U.S. Government appropriations.[48] They are executed through the FMS process, but they are not true FMS cases.[49] To enable BPC program execution through the FMS infrastructure, the DoD Implementing Agency ("**IA**") develops a "pseudo LOA," which is not signed by the foreign country, but serves to document the transfer of articles and services to the U.S. Government organization that will ultimately provide the defense articles and services to the foreign country (often this will be the Security Cooperation Office ("**SCO**") in the U.S. Embassy in the foreign country). Further, rather than relying on an LOR, the BPC process is initiated from the requesting agency, which is often the Geographic Combatant Command or the U.S. Embassy in the foreign country. The requesting agency will provide a Memorandum of Request ("**MOR**").[50] The Office of the Under Secretary of Defense for Policy ("**OUSD(P)**") is responsible for oversight of DoD-funded BPC programs, although certain authorities (for example section 1206 of the National Defense Authorization Act for Fiscal Year 2006, as amended) require concurrence by the U.S. Department of State.[51] The SCO, if it is the recipient of the defense articles, will, after inventory—and provided there are no sanctions prohibiting provision of assistance—transfer custody and responsibility of the defense articles and services to the benefitting foreign country, and will begin end use monitoring ("**EUM**," further discussed below), as applicable.

BPC programs may provide defense articles and/or services for the purpose of building the capacity of partner nation security forces and enhancing their capability to conduct counterterrorism, counter drug, and counterinsurgency operations, or to support U.S. military and stability operations, multilateral peace operations, and other programs.

C. End Use Monitoring

EUM is intended to verify that defense articles or services transferred by the U.S. Government to foreign recipients are being used in accordance with the terms and conditions to which the transfer of defense articles or services is subject.[52] Transfers made through the FMS program are subject to EUM under DoD's Golden Sentry program. Transfers made through direct commercial sales are subject to EUM under the State Department's Blue Lantern program. Recipients must agree to use U.S.-provided defense articles, training, and services only for their intended purpose; not to transfer title to, or possession of, any defense article or related training to anyone not an officer, employee, or agent of that country or of the U.S. Government without prior written consent of the U.S. Government; to maintain the security of any article with substantially the same degree of protection afforded to it by the U.S. Government; and to permit observation and review by, and to furnish necessary information to, representatives of the U.S. Government with regards to the use of such articles.[53] EUM provides U.S. Government oversight to ensure that these conditions are met.

D. Special Defense Acquisition Fund

The Special Defense Acquisition Fund ("**SDAF**") is a revolving fund that finances the acquisition of defense articles and services in anticipation of their future sale to foreign governments and international organizations. It is authorized under section 51 of the AECA.[54]

Initially capitalized with a transfer of $100 million, the SDAF is self-funding. The value of the SDAF is capped at $1.07 billion.[55] The SDAF enhances the U.S. Government's ability to meet the urgent military needs of its foreign partners by facilitating faster delivery of items and services once FMS LOAs are signed.

III. CHALLENGES FOR FMS AND DEVELOPMENTS

A. Competitions and FMS Offers

The DoD Federal Acquisition Regulation ("**FAR**") Supplement ("**DFARS**") specifically provides that, upon request from a purchaser, contracting for FMS can be done on a sole source basis.[56] In the past, many countries have identified a requirement for a specific defense article and that particular defense article through FMS. However, recently, a number of foreign countries have decided instead to define a set of requirements and to hold a competition in which one or more FMS offers would be submitted. In some cases, this is the result of the prospective purchaser being subject to new legal requirements emphasizing competition in defense contracting.[57] In other cases, the purchaser's acquisition authorities believe that a competition will result in a lower price for the defense article or more attractive offset packages – including in the area of technology transfer. The FMS offers in these competitions may be, but are not always, defense articles that can be sold only through the FMS process. In other cases, the FMS offer may be the result of a desire for a "total package approach" or the desire to leverage existing production lines or sustainment for U.S. requirements. In still other cases the offer may be a hybrid, with the main defense article being provided through direct commercial sales and classified systems, weapons, and/or upgrades being provided through FMS.

Regardless of the reason for a competition involving an FMS offer, various challenges may arise in such a competition. First, an FMS offer is from one sovereign to another sovereign. Many countries have rules for competitions that are oriented towards evaluating a proposal from a private company, and some of these rules are inappropriate for a sovereign-to-sovereign offer. For example, rules that the offeror and its personnel must be subject to the foreign country's law in case of dispute are not appropriate in the sovereign-to-sovereign context. Additionally, because the FMS program is self-funded and the U.S. Government may not incur an unfunded obligation, requirements that the FMS offer itself be a firm fixed price offer, or that the U.S. Government itself guarantee the price or the delivery date are requirements that the U.S. Government cannot agree to in an FMS offer. However, the U.S. Government can attempt to contract for a firm fixed price, guaranteed delivery schedule, or various warranties on behalf of the purchaser. There may, of course, be an increase in the price of a contract that contains such provisions. If these provisions needed to be relied on, the U.S. Government would exercise them on behalf of the purchaser, and any compensation provided by the contractor as a result would be passed on to the purchaser.

B. <u>Offsets</u>

Offsets have become an increasingly important and costly part of international armaments competitions. U.S. policy, as set forth in statute, provides that the U.S. Government shall not encourage, commit to, or enter into an offset arrangement, and that offset arrangements are matters for the contractor.[58] Further, the law provides that the decision whether to engage in offsets and the responsibility for negotiating and implementing offset arrangements, resides with the companies involved.[59] However, the U.S. Government does determine what technology may be transferred should the contractor decide to offer an offset package, and the contractor's cost for the offset may be included in the price of the FMS offer. However, FMF cannot be used to pay for offsets.[60]

Offsets present an increasing challenge as, on the one hand, foreign countries require increasing offsets, in particular in the area of technology transfer, while on the other hand, offsets can cause the price of an FMS offer to increase significantly, thereby potentially making such offers less competitive. Furthermore, a foreign country attempt to may seek commitments to offset concessions from the U.S. Government if an FMS offer is made, and complying with U.S. policy, as set forth in statute, while trying to address foreign government concerns, can be a significant challenge. Depending upon the circumstances, senior level DoD or U.S. Department of State engagement with the foreign country may be appropriate.

C. <u>International Armaments Cooperation Programs and FMS</u>

Another area in which the FMS program faces challenges is the increasing interaction between FMS and international armaments cooperation programs. These programs, carried out under different authorities than FMS sales, generally require equitable contributions and an equitable sharing of results.[61] This concept of equitable sharing is quite different from FMS, in which the foreign country is purchasing a defense article or service. When foreign countries purchase defense articles developed through international armaments cooperation programs, the interplay of the FMS rules and international cooperation rules can be confusing to foreign countries, and requires a careful legal approach to ensure results are perceived as providing FMS purchasers and international armaments cooperation participants with the fairest treatment possible.

D. Standby Letters of Credit and FMS

A current concern for many countries is expanding or upgrading forces to meet their national security requirements at a time of fiscal constraint. As a result, not only are competitions involving FMS offers increasing, but so are requests by foreign countries for standby letters of credit and requests for leasing of defense articles and for consideration of alternative financing structures. A standby letter of credit enables a foreign country to reduce or eliminate the termination liability payments it would need to provide for FMS contracts.[62] The rules and procedures regarding eligibility for, and use of a standby letter of credit in support of FMS are complex and beyond the scope of this article. Preliminary guidance regarding standby letters of credit can be found in the Security Assistance Management Manual ("**SAMM**"), and specific questions should be directed to the DSCA.[63]

E. Using Leases to Leverage Funds

Under section 61 of the AECA, DoD may lease defense articles in its stocks under certain conditions. Those conditions include ensuring that the Director, DSCA,[64] determines that there are compelling foreign policy and national security reasons for providing the defense articles on a lease rather than sales basis; the articles are not needed for public use; and the effects of the lease on the national technology and industrial base are considered, particularly the extent to which the lease reduces the opportunities of entities in the national technology and industrial base to sell new equipment to the country the articles are leased. Additionally, the country or international organization must pay all costs incurred by the U.S. Government in leasing the articles, including reimbursement for depreciation, the costs of restoration or replacement if the articles are damaged while leased, and, if the articles are lost or destroyed, the replacement cost (less depreciation) if U.S. intends to replace the articles or actual value (less depreciation) if the U.S. does not intend to replace the articles. If the defense article has passed three-quarters of its useful life, the cost of depreciation may be waived. There are also certain categories of leases for which there is no charge.[65] A lease agreement may not exceed five years, and a specified period of time required to complete major refurbishment work to be performed prior to the delivery of the leased articles. Further, at any time during the duration of the lease, the President may terminate the lease and require the immediate return of the leased articles.

F. Alternative Financing Structures and FMS

As indicated earlier, on an increasing basis contractors are seeking to use alternative financing structures in conjunction with an FMS offer in order to provide a method in which the foreign country can fulfill its requirements with fewer funds. These structures come in a variety of forms, and in some cases, the contractor considers them proprietary. It is important that contractors work closely with DSCA, as the AECA and other statutes to which the U.S. Government is subject may affect the legal viability of any proposed structure.

G. Defense Exportability Program

Another challenge facing FMS is the cost of exportability. Historically, the first purchaser paid the highest price for an exportable version of a defense article. However, not all of increased cost might qualify as a recoupable non-recurring cost. To address this, DoD sought and obtained legislation to use DoD to establish a pilot program to develop and incorporate technology protection features in designated systems during the research and development phase of such systems.[66] The legislation was subsequently amended by

Congress to require cost-sharing by industry. Specifically, the legislation provides that contracts for the design or development of systems resulting from activities under the pilot program to enhance or enable the exportability of the system shall include a cost-sharing provision requiring the contractor to bear at least one-half of the cost of such activities.[67] The pilot program was extended by 5 years in 2014, and now terminates on October 1, 2020.[68]

The goal of the program is to build in potential exportability "up front," through a cost-sharing arrangement between industry and DoD, which is intended to reduce costs for both DoD and foreign purchasers, thereby increasing commonality and interoperability, and strengthening relationships between the United States and its foreign partners.[69]

IV. FMS CONCLUSIONS

Recent experience has shown that demand for defense articles through FMS continues to be strong, although fiscal constraint and increased competition on a global scale is requiring the FMS program to adapt. As foreign countries seek to address defense requirements in an economically efficient manner, the challenges for FMS are becoming increasingly complex. As a result, creative but careful approaches are needed to ensure that FMS continues to be valuable tool in building relationships between the United States and its foreign partners.

DIRECT COMMERCIAL SALES[70]

I. AN OVERVIEW OF DCS

In addition to the U.S. Government's FMS program, U.S. Contractors[71] can sell U.S. defense articles and services to Non-U.S Purchasers[72] without the direct involvement of the U.S. Government, subject to certain regulatory hurdles and U.S. Government oversight. This type of transaction is typically referred to as a Direct Commercial Sale ("**DCS**"). DCS is like FMS in that it is as "an integral part of safeguarding U.S. national security and furthering U.S. foreign policy objectives."[73] Both FMS and DCS facilitate the interoperability of foreign military partners and U.S. forces, and thus they are seen by the U.S. Government as complementary, not competing.[74]

Still, the laws and process for DCS differ from FMS. Furthermore, avoiding tripwires and successfully conducting a DCS transaction demands a holistic and realistic understanding of how DCS works, how it differs from FMS, and how it can be safely structured—to include, where appropriate, how it can be combined with FMS in hybrid transactions. This section of paper tackles these topics, focusing on the most relevant and pressing nuances and possible pitfalls.[75]

A. The Range of DCS Options

DCS typifies the adage "you get what you negotiate." A U.S. Contractor and a Non-U.S. Purchaser have several options for structuring the DCS transaction, with the option selected determining the relative level of involvement by the Non-U.S. Purchaser and the U.S. Government, respectively, in negotiating, executing, and administering the DCS contract. Whatever the structure, though, through DCS the parties may have the flexibility to negotiate terms suiting their goals and circumstances to a greater extent than FMS might allow.

1. Traditional DCS

In a traditional DCS transaction, the U.S. Contractor and the Non-U.S. Purchaser directly negotiate almost all contract elements and terms; the U.S. Government is largely sidelined. Hence, of all the DCS forms, traditional DCS has the most direct, significant involvement by Non-U.S. Purchasers. But by extension, the Non-U.S. Purchaser must accept a significant responsibility for contract negotiation, administration, quality control, inspection, acceptance, and auditing. In the same way, the U.S. Contractor must directly address its concerns with the Non-U.S. Purchaser—to include a lack of payment or problems with contract performance.

2. Hybrid Sales—*i.e.*, DCS + FMS

A hybrid sale might include separate DCS and FMS components. DCS and FMS can both be used when there is a package of U.S. military articles or services with one or more FMS Only items. Alternatively, a Non-U.S. Purchaser might use DCS to acquire sustainment support for military articles that it acquired through FMS. Or *vice versa*, as with a Non-U.S. Purchaser that uses DCS to purchase certain military articles, but requires FMS support to obtain airworthiness certifications, training in U.S. military schools, or military transportation services.

In any event, if a hybrid sale is desired, "advance planning and coordination" are "essential."[76] For one thing, the U.S. Contractor and Non-U.S. Purchaser must ensure that the DCS and FMS components will interface seamlessly. Also, because it is not authorized to represent or to commit the U.S. Government, the U.S. Contractor should advise the Non-U.S. Purchaser of any necessary, corresponding articles or services that must be purchased through FMS. And as necessary, as early as possible in the DCS process, the Non-U.S. Purchaser should request FMS support from the U.S. Government.

3. Direct Commercial Contracting—*i.e.*, DCS + Foreign Military Financing

In limited circumstances, through transactions referred to as Direct Commercial Contracts (as defined above, "**DCC**"), some countries can use Foreign Military Financing (as defined above, "**FMF**") to finance DCS transactions. As was discussed in the first half of this paper, FMF typically is used in FMS, with the U.S. Government granting funds to a foreign country that then are spent in an FMS transaction. Nonetheless, ten foreign countries—Israel, Egypt, Jordan, Turkey, Greece, Portugal, Morocco, Tunisia, Pakistan, and Yemen—can participate in DCC.

The DSCA has published detailed guidelines describing the requirements for DCC,[77] and it approves these transactions on a contract-by-contract basis.[78] Generally, the DCS contract must be worth $100,000 or more. The contract also must be for "nonstandard" items that do not have a national stock number, and thus are not currently being used by the DoD. The FMF funds cannot be used to finance the costs of offsets. Additionally, the U.S. Contractor must be incorporated or licensed to do business in the United States, unless the DSCA has approved an offshore procurement per the procedures in the SAMM.

An additional requirement—determining the amount of U.S. content in an end item—can be difficult. With certain exceptions, defense articles to be purchased through DCC must have been (a) manufactured and assembled in the United States, (b) purchased from U.S. manufacturers or suppliers, and (c) composed of U.S.-origin materiel, components, goods, and services (commonly referred to as "**U.S. content**").[79] Thus, a U.S. Contractor must maintain and provide, if requested, supporting documentation for the value of the U.S. content and non-U.S. content, respectively, in an article to be sold via

DCC. If an item consists of both U.S. content and non-U.S. content, FMF can typically be used to finance only the value of the U.S. content.[80]

4. DCS + Outsourced Contract Management

Alternatively, a Non-U.S. Purchaser can outsource the contract administration—*e.g.*, quality control, inspection, acceptance, audits—that it must perform in a typical DCS transaction. A Non-U.S. Purchaser might conclude, for example, that it is too time-consuming, difficult, or expensive to oversee a U.S. Contractor's work in multiple geographic locations.[81] Whatever the motivation, though, these contract administration services can be contracted to the Defense Contract Management Agency ("**DCMA**"). The DCMA can develop and issue a Letter of Offer and Acceptance to a Non-U.S. Purchaser for the cost of providing these services.

5. DCS + Offsets

Further, a Non-U.S. Purchaser using DCS might require offsets from the U.S. Contractor as part of the transaction.[82] As explained in the first half of this paper, an offset is a *quid pro quo* arrangement—*i.e.*, a benefit given to a Non-U.S. Purchaser in order to induce the acquisition of U.S. military articles or services. In effect, foreign articles or services are purchased by the U.S. Contractor as a condition of sale in the DCS transaction. An offset can be direct or indirect, involving the purchase of foreign articles or services that are related or unrelated to the U.S. military articles or services being exported, respectively.

6. DCS + Articles or Services Supplied by the U.S. Government

Alternatively, the U.S. Government might supply articles or services for a DCS transaction. A U.S. Contractor will buy military articles or services from the U.S. Government, then sell the articles or services in a DCS transaction. For marketing and planning purposes, the U.S. Government can provide non-binding cost and delivery estimates. But even then, the U.S. Government will sell the articles or services only under the following conditions:

- The U.S. Contractor has an approved export license (which this paper discusses in greater detail below);
- The U.S. Contractor intends to incorporate the articles or services into end items being sold in a DCS transaction;
- The end items are for the armed forces of a friendly country or international organization;
- In the case of articles, the U.S. Government would supply the articles as government-furnished equipment or material if the end item were being procured by the DoD;
- In the case of services, the U.S. Government services must be performed within the United States; and
- The articles and services are available only from the U.S. Government, or they are not commercially available on the U.S. Contractor's delivery schedule.[83]

B. <u>The Negotiable Terms of a DCS Transaction</u>

DCS also provides a "greater degree of flexibility" for negotiating contract terms.[84] Indeed, when negotiating a DCS transaction, there is "no structured, regulatory guidance, such as the FAR, that must be followed[,] as is the situation with FMS."[85] DCS thus appeals to those that "wish to participate actively in tailoring the procurement process."[86] A DCS contract negotiation could address, any (or all) of the following, among other things:

- The type of contract—*e.g.*, fixed-price; cost-reimbursement; time-and-materials; and otherwise.
- Basic terms—*e.g.*, language (English or foreign) and currency (U.S. or foreign).

- Financial terms—*e.g.*, price; payment schedule; method of payment; security for payment; use and availability of financing; repatriation of funds; and tax planning, including transfer pricing.

- Specific delivery requirements—*e.g.*, risk of loss; passage of title; packaging; storing; and other logistical issues.

- Inspection and performance responsibilities, specifications, and standards.

- Post-sale service and support—*e.g.*, training; maintenance; spare parts; and repairs—and warranties.

- Issues and choices of law and disputes—*e.g.*, types and methods of breach; penalties for breach; applicable law (U.S., foreign, and multinational, including treaties); local registration and licensing; tariffs and customs; domestic preferences; alternative dispute resolution; forum selection; sovereign immunity of U.S. and foreign entities; and domestic and international *force majeure*.

- Insurance coverage.

- Intellectual property protection.

- Terms for confidentiality and non-disclosure.

In the end, the parties to a DCS transaction must assume different (and often greater) responsibilities and risks.[87] Not only must U.S. Contractors be "very knowledgeable about their products," but they must have the business and legal acumen and resources to handle an international transaction, to assume the greater overhead management costs of negotiating and closing the contract, and to internationally "deliver quality items and services in accordance with the contract provisions."[88] Meanwhile, a Non-U.S. Purchaser attracted to DCS is often savvy, with "extensive business ties to the West," and with "knowledge[] of US law and financing[.]"[89] Additionally, a Non-U.S. Purchaser "must be prepared to address the contractor directly to resolve any issues that arise."[90]

II. THE LEGAL FRAMEWORK FOR DCS: U.S., FOREIGN & INTERNATIONAL LAW

While the FMS process has its own statutory authority, DCS is covered by a mélange of U.S., foreign, and international laws. This section provides a broad overview of these issues.

A. U.S. Law

The U.S. laws that apply to international military sales can be thought of as falling within two broad policy goals: (1) promoting U.S. national security and foreign policy; and/or (2) averting corruption, fraud, and waste.

1. Promoting U.S. National Security and Foreign Policy

At the outset, "[a]ll sales of defense articles or services, FMS or DCS, must promote U.S. strategic and foreign policy interests."[91] For that reason, all FMS and DCS transactions are subject to U.S. "trade controls"—*i.e.*, U.S. export controls, economic sanctions, and anti-boycott laws and regulations. Trade controls ensure that these transactions occur in a manner consistent with U.S. national security and foreign policy.

Still, trade controls compliance can be more complex and risky with DCS than with FMS because of the larger and more varied DCS market, and because certain rules that apply to FMS, such as the licensing exemption provided by section 126.6 of the International Traffic in Arms Regulations ("**ITAR**"), do not apply to DCS. As discussed below, in addition to understanding the applicable trade controls laws and regulations of the purchasing country, the parties must understand the U.S. Government's (a) export control laws, (b) international economic sanctions, and (c) anti-boycott laws and regulations. This burden is all the more on U.S. Contractors, given the stiff penalties for noncompliance.

a) U.S. Export Control Laws

As a threshold matter, U.S. export control laws regulate exports and reexports of goods, technology, and software based on the destination, end-use, and end-user. This includes physical exports from the United States to a foreign country and also includes cross-border electronic transmissions of software or technology (*e.g.*, telephone calls, e-mail, and downloads from remote computer servers), the disclosure or transfer of technical data or software source code to a non-U.S. person in the United States, and defense services provided on behalf of, or for the benefit of, a non-U.S. person in the United States or abroad. Further, they can adhere to U.S.-origin items even after an initial export; in this way, they can regulate reexports and retransfers of certain goods, software, and technology from one non-U.S. person to another non-U.S. person, or from one foreign country to another foreign country. The applicable requirements vary based on the export jurisdiction and classification of the articles or services, the identities of Non-U.S. Purchasers, the identities of end-users of the items, and the intended end uses for the items.

Pursuant to the U.S. export control regime, DCS transactions must comply with the U.S. Government's export licensing requirements. Here, the U.S. Department of State, Directorate of Defense Trade Controls ("**DDTC**"), and the U.S. Department of Commerce, Bureau of Industry and Security ("**BIS**"), exercise primary jurisdiction.[92] Traditionally, DDTC has exercised jurisdiction over transactions involving defense articles and services. BIS exercises jurisdiction over transactions involving commercial or "dual-use" (*i.e.*, both commercial and military) articles and services. Both agencies could have jurisdiction over a DCS transaction. However, as a result of recent U.S. export control reforms, BIS has acquired increased jurisdiction over certain defense items. For example, DDTC often licenses the export and reexport of key end-items (*e.g.*, fighter aircraft), while BIS authorizes the export and retransfer of many of the end-items' parts, components, accessories, attachments, and associated equipment (*e.g.*, aircraft tires; filters; brake wear pads; and cockpit-panel knobs, indicators, switches, buttons, and dials).

DDTC oversees the export, reexport, or retransfer of defense articles and services (including technical data[93]) to non-U.S. persons and non-U.S. destinations pursuant to the ITAR.[94] The ITAR set registration, licensing, and reporting requirements for U.S. manufacturers, exporters, and brokers of defense articles. They also impose approval requirements on certain transactions by non-U.S. parties (*e.g.*, retransfers of U.S.-origin defense articles from one non-U.S. entity to another, including where the U.S. items are incorporated in non-U.S. origin products).

With some exceptions, a DDTC license or other approval is required for the export, reexport, retransfer, or temporary import of a defense article and service (including technical data). U.S. Government arms embargoes and other proscriptions bar some foreign countries, including China,[95] from receiving any defense articles or services (including technical data) subject to the ITAR. DDTC prohibits the release of any articles or services (including technical data) subject to the ITAR to these countries, companies incorporated in these countries, or other companies owned or controlled by the government or companies of these countries. DDTC also closely restricts exports to any individual that is a national of one of these countries, whether that release occurs in the United States or abroad, absent a license, approval, or exemption.

Meanwhile, BIS oversees transactions involving commercial and dual-use items, exercising its jurisdiction pursuant to the Export Administration Regulations ("**EAR**").[96] BIS has broad authority to regulate virtually all exports from the United States that are not subject to the jurisdiction of another agency (*e.g.*, DDTC), and to regulate reexports from one non-U.S. country to another of U.S. items or of non-U.S. products that contain more than *de minimis* U.S. content. That said, BIS controls only a small subset of such exports, based on the sensitivity of the item, as well as the nature of the end-use and end-user.

b) U.S. Economic Sanctions

Additionally a DCS transaction must comply with the U.S. trade and economic sanctions programs and regulations administered by the U.S. Department of the Treasury, Office of Foreign Assets Control ("**OFAC**").[97] Absent a specific or general license from OFAC, U.S. sanctions bar DCS transactions with certain countries, individuals, and entities. OFAC programs currently impose strict controls on transactions involving Cuba, Iran, North Korea, the Republic of Sudan (but not the Republic of South Sudan), and Syria. A U.S. Contractor cannot participate in a DCS transaction with one of these countries, nor can it release technology or technical data to a national of one of these countries (with some limited exceptions), whether that release occurs in the United States or abroad. Similarly, all U.S. persons (including U.S. companies and individuals), wherever they are located, are prohibited from engaging in DCS transactions with individuals or entities (*e.g.*, shipping vessels, freight transporters or forwarders, end-users, consignees, subcontractors, teaming partners, agents, brokers) named on any U.S. Government list of restricted parties, including the U.S. Department of Commerce's Denied Parties List and Entity List and OFAC's list of Specially Designated Nationals.[98]

c) U.S. Anti-Boycott Laws and Regulations

Further, the U.S. Government anti-boycott requirements that apply to DCS prohibit a U.S. Contractor from participating in or cooperating with an international boycott that has not been endorsed by the U.S. Government. Although it is not the only target, the primary aim of these anti-boycott programs is the Arab League boycott of Israel.[99]

The U.S. Government enforces two separate sets of anti-boycott laws and regulations. The first is administered by the U.S. Department of Commerce through the EAR.[100] The other set is administered by the U.S. Department of the Treasury.[101] These laws have different, complicated, and occasionally inconsistent requirements.[102] Suffice it to say, however, that violations of the EAR regulations can result in substantial civil or criminal penalties and/or the loss of export trading privileges. The Treasury regulations do not prohibit any conduct *per se*, but they penalize boycott participation and cooperation by imposing additional income taxes on a U.S. taxpayer (and members of the taxpayer's controlled group, as defined in Internal Revenue Code ("**IRC**") section 993(a)) if it agrees to participate in or cooperate with a boycott that is not endorsed by the U.S. Government.

Finally, with limited exceptions, these anti-boycott programs require a U.S. Contractor to report boycott requests that it receives (even if it refused to comply with the request). Under the EAR, a report must be filed with the U.S. Department of Commerce within thirty days after the end of the calendar quarter in which the request was received (or within sixty days if it was received outside of the United States). The IRC requires reports to the U.S. Department of the Treasury, with the filing of the U.S. Contractor's annual tax return.

2. Averting Corruption, Fraud, and Waste

Furthermore, DCS is subject to U.S. laws and regulations meant to protect the integrity of procurements and transaction participants, and, relatedly, to avert corruption, fraud, and waste.

a) Foreign Corrupt Practices Act

The U.S. Foreign Corrupt Practices Act ("**FCPA**") establishes strict anti-bribery safeguards and also bookkeeping and accounting requirements.[103] Both U.S. Contractors and Non-U.S. Purchasers must understand how the FCPA applies to DCS transactions, as expansive FCPA jurisdiction has been asserted over both U.S. persons and over non-U.S. persons. The U.S. Government has applied the FCPA to U.S. companies; U.S. nationals; permanent U.S. residents; agents and representatives; foreign affiliates, subsidiaries, and joint ventures of U.S. companies; and U.S. affiliates, subsidiaries, and joint ventures of foreign companies.

(1) FCPA Anti-Bribery Provisions

The FCPA's anti-bribery provisions prohibit any act "in furtherance of" the "bribery" of a foreign official—*i.e.*, a payment, offer to pay, promise to pay, or authorization to pay money or anything of value that is meant to influence the recipient's official duties, or to secure an improper advantage in obtaining or retaining business. On these bases, the payment of any currency with a corrupt intent, no matter how small the amount, can be a bribe; also, a bribe can be a non-cash gift, charitable contribution, donation, expense reimbursement, or a mere promise of future payment. A payment intentionally made to influence or win a contract award can be a bribe, but so too can one that is meant to buy non-public information, or circumvent laws and regulations, or reduce customs duties, taxes, administrative fees, or penalties. Plus, a foreign official can be a high-level or low-level officer or employee, a person acting on a foreign government's behalf, a state-owned business, a party official, or a candidate for office.[104]

(2) FCPA Bookkeeping and Accounting Requirements

Separately, the FCPA's bookkeeping and accounting requirements apply to "issuers" of securities that are registered under the Securities Exchange Act of 1934. An "issuer" can be a U.S. or foreign company, public or private. The FCPA requires that an issuer maintain accurate books and records, and it prohibits the falsification of books and records. Relatedly, the FCPA requires that an issuer have adequate accounting controls—essentially, accounting practices that conform to Generally Accepted Accounting Principles and provide a prudent official with reasonable assurances that the issuer's transactions are properly authorized and recorded. Circumventing or failing to implement adequate accounting controls is prohibited. An issuer also is responsible for the accounting controls and practices of its subsidiaries and affiliates.[105]

(3) FCPA Fines and Penalties

FCPA fines and penalties are assessed per violation and can compound quickly. A company's violation of the anti-bribery provisions triggers a criminal fine of up to $2 million and a civil fine of up to $10,000, plus penalties of twice the amount of the pecuniary gain resulting from the FCPA violation.[106] A company's violation of the bookkeeping and accounting requirements is punishable by a criminal fine of up to $25 million and a civil penalty of either twice the amount of its pecuniary gain or an amount up to $500,000, whichever is greater.[107]

b) Money Laundering Control Act

Although "money laundering" commonly refers to cleaning money of the taint of criminal activity, the U.S. Government's criminal money laundering statutes outlaw a broader swath of conduct. Of these statutes, the U.S. Money Laundering Control Act

("**MLCA**") is the most prominent.[108] It prohibits U.S. persons and non-U.S. persons from participating in a transaction if knowingly using, depositing, transferring, or concealing proceeds from a "specified unlawful activity," or if knowingly promoting a "specified unlawful activity." A "specified unlawful activity" can be under any of the hundreds of federal, state, and foreign laws that the MLCA has incorporated by reference, including the FCPA, export-related offenses, and bribery-related offenses. Thus, when a U.S. Contractor or Non-U.S. Purchaser is charged with violating one of these statutes, it might face criminal charges under the MLCA, as well. And depending upon the section of the MLCA that has been violated, an offender faces a fine of up to $500,000 or twice the value of the property involved in the transaction, plus twenty years' imprisonment.

c) Suspension and Debarment

A strict suspension and debarment system bars U.S. Contractors from doing business with the U.S. Government if they have been debarred, suspended, or proposed for debarment.[109] Similar regulations apply to DCS. For instance, a U.S. Contractor or Non-U.S Purchaser that violates the ITAR or EAR can be suspended or debarred, and thus prohibited from participating in a DCS transaction.[110] In fact, if a U.S. Contractor is found to be ineligible for whatever reason by any federal agency, it can be barred from obtaining an export license.[111] Relatedly, an export license can be denied, revoked, suspended, or amended when "any party to the export or agreement, any source or manufacturer of the defense article or defense service[,] or any person who has a significant interest in the transaction" has been debarred, suspended, or proposed for debarment.[112] Regulations also prohibit U.S. Contractors and Non-U.S. Purchasers from applying for, obtaining, or using an export license to benefit a party that is known to be ineligible, nor can they "order, buy, receive, sell, deliver, store, dispose of, forward, transport, finance, or otherwise service or participate" in a DCS transaction if it could benefit a party known to be ineligible.[113]

d) Risks and Exposure Attributable to Third-Parties

As a final matter, third-party intermediaries, representatives, brokers, and/or agents are often used by U.S. Contractors and Non-U.S. Purchasers when pursuing, negotiating, or consummating a DCS transaction. These relationships create an additional layer of complexity and risk for DCS transactions, as third-party conduct can be imputed to a U.S. Contractor or Non-U.S. Purchaser across a range of circumstances.

In the end, DCS participants must appropriately account for these risks in their risk management and compliance programs, but also in the manner in which they negotiate, structure, and consummate a DCS transaction. As discussed above, third-party conduct is relevant to the application of export controls and sanctions. A third party also might violate foreign laws, as noted below. Or, as is relevant here, a third party can violate U.S. anticorruption laws and regulations. Under the FCPA, an organization can be held liable not only for its own actions, but also for actions taken on its behalf, which the organization either knew of or (explicitly or implicitly) authorized. Noncompliant activities by a third-party intermediary also trigger many bribery cases.

B. Foreign Law

Executed DCS sales are international transactions and thus must comply with foreign laws and regulations, as well. The most relevant and pressing of these are discussed below.

1. United Kingdom Bribery Act of 2010

A U.S. Contractor or Non-U.S. Purchaser could violate the United Kingdom ("**UK**") Bribery Act of 2010 ("**UK Bribery Act**").[114] Broader than the FCPA, the

UK Bribery Act prohibits giving, receiving, and failing to stop bribes.[115] And even a non-UK entity can violate the UK Bribery Act, as can occur when part or all of a bribery offense happens in the UK; when an offender maintains a "close connection" with the UK; or, in certain circumstances, when a non-UK entity is a "commercial organization"[116] that conducts business in the UK.

Specifically, the UK Bribery Act criminalizes giving any offer, promise, or gift of any advantage to "another person"[117] if done with the intent to induce or to reward the improper performance of a function or activity. It criminalizes giving any offer, promise, or gift of any advantage to another person if it is known or believed that the mere acceptance of the advantage would constitute the improper performance of a function or activity. It separately criminalizes giving any offer, promise, or gift of any advantage to a "foreign public official"[118] if it is intended to influence the official and result in obtaining or retaining business or a business advantage. It criminalizes requesting, agreeing to receive, or accepting a bribe. And, it criminalizes the failure of a commercial organization to prevent a bribe by one of the organization's agents, employees, or subsidiaries.[119] A criminal conviction under the UK Bribery Act is punishable by, among other things, permanent debarment from public contracts in the European Union.

2. Foreign Government Offset Requirements

Well over one hundred countries use (and often require) offsets. Further, U.S. law requires that U.S. Contractors submit an annual report identifying, among other things, all offset agreements exceeding $5,000,000 in value.[120] In practice, though, a U.S. Contractor may find that Non-U.S. Purchasers' offset requirements are neither uniform, nor practical, nor compliant with U.S. law. For example, a developing country might require that a majority of a DCS contract's supplies and services come from firms within that country;

this requirement, however, could overlook serious industrial base or labor market deficiencies. A Non-U.S. Purchaser might require that offsets be direct, indirect, or a combination of the two, or it might specify foreign firms that are eligible to receive an offset award. A Non-U.S. Purchaser might incentivize certain purchases or investments by applying a "multiplier" to the value of these offset commitments. Another might stipulate that offset commitments must be satisfied within a certain time period, or that offset obligations can be transferred to different contract instruments or contracting parties. Some Non-U.S. Purchasers impose contractual or financial penalties if a U.S. Contractor fails to satisfy an offset commitment. All in all, these divergent systems, requirements, and practices create tremendous financial, management, and compliance challenges.

3. Other Foreign Laws

Additionally, a DCS transaction will likely be subject to the national and local laws of the Non-U.S. Purchaser. Too numerous and diverse to summarize, foreign laws pose unique management and compliance challenges. Indeed, foreign procurement or anti-corruption law might conflict with U.S. law. Alternatively, foreign law might complicate or conflict with the commercial interests of a U.S. Contractor. There might be extensive licensing and registration requirements, tariffs, or import fees. Foreign subcontractors, partners, or teammates might benefit from generous immunities. Similarly, the foreign labor market might enjoy significant hiring preferences and employment benefits.

C. <u>International Law</u>

Lastly, international agreements such as the World Trade Organization Government Procurement Agreement ("**GPA**") and the Organisation for Economic Co-operation and Development ("**OECD**") Anti-Bribery Convention ("**Convention**") could apply to DCS transactions. Over forty members of the WTO have signed the GPA,[121] a framework of rights and obligations for non-discrimination and transparency in government procurements. But even so, the GPA unevenly applies to sales of military articles and services; for one thing, although it prohibits offsets, two frequently-invoked exceptions—offsets can be used by developing countries, or by any country if necessary to protect its national security interests—can swallow the rule. Likewise, the OECD Convention is meant to criminalize bribing a foreign public official, but it leaves the Convention's implementation and enforcement to the forty signatories, not to the OECD.[122] These country-by-country efforts have been described as lax and inconsistent.[123] In short, along with the GPA and the Convention, other international procurement and anti-corruption agreements might apply,[124] but with debatable influence and efficacy.[125]

SELECTING BETWEEN FMS AND DCS

Plainly, whether to pursue an international sale through FMS or DCS is a complicated decision. U.S. laws and regulations set certain restrictions. Additionally, a foreign purchaser might expect certain features available only through FMS or DCS. And even where these factors do not dictate that FMS be used, the flexibility of DCS must still be weighed against significant countervailing concerns.

This section describes these issues.

I. U.S. GOVERNMENT RESTRICTIONS

The U.S. Government can designate that certain military articles and services are for sale on an FMS Only basis. This designation bars the use of DCS, and it is assigned based on four criteria: (1) legislative/Presidential restrictions; (2) DoD policies, directives, or regulatory requirements; (3) government-to-government agreements; and (4) interoperability/safety requirements of the U.S. military.[126]

Accordingly, an FMS Only designation is based on the U.S. Government's political, military, and/or national security concerns, and it gives the U.S. Government exclusive control over the sale of certain military articles or services to Non-U.S. Purchasers. Sales of major weapon systems, even if done through DCS, will often require an accompanying FMS case. Advanced military technology is often designated as FMS Only. Man-portable air defense missiles, cryptographic equipment, precise geo-locational positioning technologies, and airborne early warning and control systems have been designated as FMS Only, as well.[127]

By contrast, for articles and services that have not been designated as FMS Only, a U.S. Contractor can request a DCS Preference from the DSCA. On the surface, a DCS Preference functions like an FMS Only designation, but to the benefit of a U.S. Contractor.

When a DCS Preference has been awarded, the U.S. Government should not make the articles and services available through FMS; rather, the U.S. Government should re-direct any purchase requests that it receives to the U.S. Contractor with the DCS Preference. But a DCS Preference differs from an FMS Only designation in two ways: (1) it is valid for only one year, subject to renewal; and (2) it does not categorically bar the U.S. Government from opening an FMS transaction. The U.S. Government gives only a "best efforts" commitment to honoring a DCS Preference, and its failure to comply with a DCS Preference "will not invalidate any resultant FMS transaction."[128]

Generally, the U.S. Government will stop work (or will not commence work) on a proposal for an FMS offer with a Non-U.S. Purchaser that has requested or that is negotiating a DCS contract for the same articles or services from the same provider. Likewise, the U.S. Government asks that a Non-U.S. Purchaser cancel any requests for FMS data if it will pursue the same articles or services through DCS.[129]

II. PREFERENCES OF FOREIGN CUSTOMERS

Foreign customers may wish to use the FMS process over DCS based on a number of considerations. These may include "system cost, performance, delivery schedule, life cycle logistics support, interoperability, and industrial utilization as well as the political relationship with the selected source nation."[130] Furthermore, the FMS process can also allow countries to leverage existing DoD contracts, and thereby get lower prices resulting from larger production runs. Some countries also prefer to allow the DoD to perform the contract negotiations, others prefer the transparency provided by the U.S. acquisition system, and many prefer the "total package approach" provided by FMS.[131] The total package approach can provide a foreign country not only with a weapon platform such as a fighter aircraft, but also with the weapons, sustainment, and training needed for operational use of that weapon platform.

III. Other Important Considerations

As noted, for DCS-eligible services and articles, a DCS sale might offer greater flexibility to structure, negotiate, and execute contract terms that are tailored to the parties' respective needs and goals. Many contractors gravitate to these advantages. Still, there are countervailing considerations that must be considered, as summarized below[132]:

Potential Contracting Advantage of DCS	**Countervailing Consideration**
With DCS, the parties can freely structure the transaction and negotiate more appropriate cost and contract terms.	The U.S. Contractor and Non-U.S. Purchaser must have sufficient business and legal resources and acumen.
As a commercial transaction, DCS is not subject to many of the legal and regulatory requirements of FMS, and thus might be negotiated and finalized more flexibly and rapidly.	Again, the U.S. Contractor and Non-U.S. Purchaser must have the resources and acumen to bear these responsibilities and risks; further, if the Non-U.S. Purchaser actually desires a closer military relationship with the U.S. Government, then FMS (and its unique requirements) might be more attractive. And even with DCS, the U.S. Government must still approve an export license, as discussed further, below.
DCS allows a Non-U.S. Purchaser to acquire nonstandard, uniquely-tailored packages of articles and services that are not available via FMS.	Nonstandard, unique items articles and services might need to be integrated and/or standardized with other articles or services, or require a greater degree of follow-on support services from the U.S. Contractor or U.S. Government. Some Non-U.S. Purchasers prefer the "total package" approach available through FMS.
With DCS, the Non-U.S. Purchaser has greater freedom to insist on offsets.	As explained in the first half of this paper, FMS also permits offsets—although, they must be negotiated directly with the U.S. Contractor, not the U.S. Government.
DCS may obviate many costs that increase the price of FMS transactions—*e.g.*, administrative surcharges. However, administrative costs of DCS can be significant, depending upon the facts of the proposed transaction.	Depending upon the ability of the negotiating parties, DCS prices can rival or exceed those of FMS; also, DCS still might demand follow-on services, support, and article integration.

At bottom, a U.S. Contractor wishing to begin selling (or to expand sales) of articles or services through international sales to foreign buyers must consider these issues, as well as the full range of other issues set forth in this paper. As the international military sales market continues to expand, having the expertise to navigate these highly-regulated waters is essential. While a single paper cannot provide complete coverage for topics as complex and dynamic as these, the authors hope that this paper will be a good starting point for U.S. Contractors looking to this international market.

REFERENCES

[1] *See* DSCA, *Fiscal Year Series* (as of Sept. 30, 2012) at 2, http://www.dsca.mil/sites/default/files/fiscal_year_series_-_30_sep_2012.pdf. (reflecting $30.15 million for DCS compared to $11.49 million for FMS).

[2] These are data for unclassified exports of military articles. *See* GAO-10-952 Report at i. Data are not available for DCS's contributions to classified export transactions, or to sales of military services. *Id.* at 2, 13, 17.

[3] *Id.* at 7-8. DCS and FMS were used in roughly equal measure for the next largest categories—*e.g.*, vehicles, weapons and parts; other equipment and parts; missiles and parts; ammunition, explosives, and parts; firearms and parts; and ships and parts. *Id.*

[4] *E.g.*, Sandra I. Erwin, *U.S. Firms Rule Global Arms Market, But Dominance May Not Last*, National Defense Magazine Blog (December 8, 2013), http://www.nationaldefensemagazine.org/blog/lists/posts/post.aspx?ID=1359. Even sterner competition can come from foreign firms that are unimpeded by the complicated U.S. laws and regulations that govern U.S. Contractors participating DCS transactions.

[5] This section was authored by Derek Gilman, General Counsel, Defense Security Cooperation Agency.

[6] 22 U.S.C. § 2751.

[7] Defense articles include any item or technical data designated on the U.S. Munitions List ("USML") contained at 22 C.F.R. § 121.1.

[8] Defense services include: (1) the furnishing of assistance (including training) to foreign persons, whether in the United States or abroad in the design, development, engineering, manufacture, production, assembly, testing, repair, maintenance, modification, operation, demilitarization, destruction, processing or use of defense articles; (2) the furnishing to foreign persons of any technical data controlled under the USML, whether in the United States or abroad; or (3) military training of foreign units and forces, regular and irregular, including formal or informal instruction of foreign persons in the United States or abroad or by correspondence courses, technical, educational, or information publications and media of all kinds, training aid, orientation, training exercise, and military advice. *See* 22 C.F.R. § 120.9.

[9] 22 U.S.C. § 2761 and 22 U.S.C. § 2762.

[10] 22 U.S.C. § 2321j.

[11] See Executive Order 13637, March 8, 2013 (superseding Executive Order 11958, as amended of January 18, 1977, delegating the President's authority with respect to these matters to the Secretary of Defense); DoD Directive 5105.65, October 26, 212 (further delegating the authority to the Director of the Defense Security Cooperation Agency).

[12] 22 U.S.C. § 2752.

[13] Article 3 of the AECA, 22 U.S.C.§ 2753.

[14] An LOR may be preceded by marketing activities by the contractor. If the contractor requests an advocacy letter from the Department of Commerce and there is no other U.S.-origin defense article that is anticipated to compete, the Department of Defense may advocate for that defense article. If there is more than one U.S.-origin defense article that may compete, DoD may only provide generic advocacy (*e.g.*, either U.S. defense article offered in the competition would address the country's requirements). Further, the DoD may undertake certain pre-LOR activities in anticipation of receiving an LOR. Pre-LOR activities are those necessary to enable the foreign country to define requirements sufficiently to produce a complete LOR. *See* SAMM, C9.3.4.

[15] In Section C5.1.2, the SAMM states that an LOR should:

> 1. Identify the desired defense articles and/or services in sufficient detail for the United States Government (U.S. Government) to prepare an accurate cost estimate.
>
> 2. Indicate whether Price and Availability (P&A) data, a Letter of Offer and Acceptance (LOA), an LOA Amendment, or an LOA Modification is desired.
>
> 3. If for a blanket order LOA, include the desired materiel and services value or the desired total case value.
>
> 4. Indicate the proposed method of financing.
>
> 5. Identify any anticipated involvement in the requested case by anyone not a duly appointed officer or government civilian employee of the requesting government—*i.e.*, a "third party"—so that the receiving Military Department/Implementing Agency may initiate appropriate reviews and approval requests.
>
> 6. Contain the name and address of the originator and a traceable reference number, *e.g.*, letter serial number.
>
> 7. Identify the intended/anticipated recipient unit for any defense articles and/or services to be purchased with FMF, recognizing such unit designations may change as the case is implemented and equipment is delivered to the host nation.

[16] For DoD, the LOA is signed by a representative of the Implementing Agency and the Director of the DSCA.

[17] *See* SAMM, C5.F.4.

[18] Paragraph 2.2. of the LOA Standard Terms and Conditions tracks Section 4 of the AECA (22 U.S.C. § 2754) and provides:

> The Purchaser agrees, except as may otherwise be mutually agreed in writing by the Purchaser and the U.S. Government, to use the defense articles sold hereunder only: 2.2.1. for

> internal security; 2.2.2. for legitimate self-defense; 2.2.3. for preventing or hindering the proliferation of weapons of mass destruction and of the means of delivering such weapons; 2.2.4. to permit the Purchaser to participate in regional or collective arrangements or measures consistent with the Charter of the United Nations, or otherwise to permit the Purchaser to participate in collective measures requested by the United Nations for the purpose of maintaining or restoring international peace and security; or 2.2.5. for the purpose of enabling foreign military forces in less developed countries to construct public works and to engage in other activities helpful to social and economic development. 2.2.6. for purposes specified in any Mutual Defense Assistance Agreement between the U.S. Government and the Purchaser; or, 2.2.7. for purposes specified in any other bilateral or regional defense agreement to which the U.S. Government and the Purchaser are both parties.

[19] LOA Standard Terms and Conditions, ¶¶ 2.3-2.6 and 4.4.

[20] LOA Standard Terms and Conditions, ¶¶ 3.1-3.2.

[21] LOA Standard Terms and Conditions, ¶ 5.1.

[22] FMF is appropriated in the annual U.S. Department of State, Foreign Operations, and Related Programs Appropriations Act.

[23] *See, e.g.*, Foreign Military Financing appropriation under International Security Assistance in U.S. Department of State, Foreign Operations, and Related Programs Appropriations Act, 2014, P.L. 113-76, Division K, Title IV.

[24] *See id.*

[25] *See id.*

[26] The ten countries eligible for DCCs are: Israel, Egypt, Jordan, Morocco, Tunisia, Turkey, Portugal, Pakistan, Yemen, and Greece.

[27] "Guidelines for Foreign Military Financing of Direct Commercial Contracts" at http://www.dsca.mil/resources/foreign-military-financing-direct-commercial-contracts-fmf-dcc. *See also* SAMM, C.9.7.3.

[28] Section 21(b) of the AECA (22 U.S.C. § 2761(b)).

[29] Section 22(a) and (b) of the AECA (22 U.S.C. §§ 2762(a), (b)) and Section 21(d) of the AECA (22 U.S.C. § 2761(d)).

[30] SAMM, C9.8.3; *see also*, DSCA Policy Memo 09-07, published July 17, 2007, available at http://www.samm.dsca.mil/policy-memoranda/dsca-09-07.

[31] AECA Sections 21 (22 U.S.C. § 2761) and 22 (22 U.S.C. § 2762).

[32] DoD Financial Management Regulation 7000.14-R, Volume 15; OMB Circular A-11.

[33] SAMM C9.7.3.

[34] The DCC Guidelines can be found at: http://www.dsca.mil/resources/foreign-military-financing-direct-commercial-contracts-fmf-dcc

[35] *See* SAMM, C9.9.1.5.3. If available, contractor termination schedules are used to calculate TL for a specific FMS case. If contract schedules are not available, the TL component of the payment schedule curve is used. If that is not available either, the "DoD Standard Curve" is used. *See* DoD Financial Management Regulations 7000.14-R, Volume 15, Chapter 7.

[36] Detailed information on standby letters of credit is available in SAMM, C9.9.1.5.4. FMF programs are not eligible for standby letters of credit.

[37] SAMM, C9.11.2.

[38] SAMM, C9.11.3.

[39] Section 21(e)(1) of the AECA (22 U.S.C. § 2761(e)(1)).

[40] Section 47(6) of the AECA (22 U.S.C. § 2794(6)).

[41] Section 21(e)(2) of the AECA (22 U.S.C. § 2761(e)(2)).

[42] *Id.*

[43] 32 C.F.R. Part 165; DoD FMR Vol. 15, Chap 7, ¶ 070305. *See also* DoD Directive 2140.02.

[44] Section 61 of the AECA (22 U.S.C. § 2796). The lease may extend to a specified period of time required to complete major refurbishment work prior to delivery. The foreign country or international organization must be eligible for FMS in order to be eligible to lease defense articles.

[45] *Id.*

[46] Foreign Assistance Act Section 505 (22 U.S.C. § 2314). Additionally, to receive grant EDA, a country must be justified to Congress for the fiscal year in which the transfer is proposed via the annual notification letters to Congress with U.S. Department of State concurrence. Justification to Congress and eligibility does not guarantee that any EDA offers will be made on a grant basis, as each request for EDA is considered individually. *See* SAMM, C11.3.2.2.

[47] DoD FMR 7000.14-R, Volume 15, Chapter 7

[48] Congress generally appropriates funds for BPC programs carried out using DoD authorities through the annual Department of Defense Appropriations Act. In certain cases, Congress will make appropriations for BPC programs through other legislation. For example, for several years Congress appropriated funds for the BPC authorities for Iraq and Afghanistan in annual "supplemental appropriations." Congress appropriates funds

for BPC programs carried put using U.S. Department of State authorities in the annual U.S. Department of State, Foreign Operations, and Related Programs Appropriations Act.

49 For BPC programs authorized under DoD authorities (such as section 1206 of the National Defense Authorization Act for Fiscal Year 2006, as amended) are executed using the FMS infrastructure under the authority of the Economy Act (31 U.S.C. §§ 1535, 1536). BPC programs authorized under U.S. Department of State authorities (most notably programs using Peacekeeping Operations funds) are executed under the authority of Section 632(b) of the Foreign Assistance Act.

50 SAMM, C15.1.2.1.

51 SAMM, C15.1.3.2.

52 *See* SAMM, Chapter 8.

53 *See* Section 505 of the Foreign Assistance Act and Sections 3 and 4 of the AECA (22 U.S.C. §§ 2753, 2754); the LOA Standard Terms and Conditions.

54 22 U.S.C. § 2795.

55 10 U.S.C. § 114.

56 DFARS 225.7304

57 *See, e.g.*, European Commission Directive 2009/81/EC on Defence and Security Procurement.

58 Defense Production Act Amendments of 1992, P.L. 102-558, Sec. 123.

59 *Id.*

60 Defense Production Act Amendments of 1992, P.L. 102-558, Sec. 123. Additional information on offsets is available on the Defense Procurement and Acquisition Policy website: http://www.acq.osd.mil/dpap/cpic/ic/offsets_of_foreign_military_sales.html.

61 *See* 10 U.S.C. § 2350a and section 27 of the AECA (22 U.S.C. § 2767).

62 *See* SAMM, C9.9.1.5.4 (discussing standby Letters of Credit).

63 *Id.*

64 Section 61 provides the authority to the President. However, the President delegated this authority to the Secretary of Defense through Executive Order 13637. The Secretary of Defense, in turn, delegated this authority to the Director, DSCA, through DoD Directive 5105.65.

65 *See* Section 61 of the AECA (22 U.S.C. § 2796). There is no charge for leases entered into for purposes of cooperative research or development, military exercises, or communications or electronics interface projects. Additionally, the President may waive the requirement for reimbursement of depreciation for any defense article which has passed three-quarters of its normal service life if the President determines that to do so is important to the national security interest of the United States. The President may waive the requirement for payment with respect to a lease which is made in exchange with the

lessee for a lease on substantially reciprocal terms of defense articles for DoD, provided notification is made to Congress

66 Section 243 of the Ike Skelton National Defense Authorization Act for Fiscal Year 2011 (P.L. 111-383).

67 Section 252 of the National Defense Authorization Act for Fiscal Year 2012 (P.L. 112-81).

68 Section 264 of the National Defense Authorization Act for Fiscal Year 2014 (P.L. 113-66).

69 *See* "Defense Exportability Features," available at http://www.acq.osd.mil/ic/DEF.html. The website indicates that the defense exportability program "is a key feature identified in 'Control Costs Throughout the Product Lifecycle' section of (USD)AT&L's Better Buying Power Initiative 2.0." More information about the Better Buying Power initiative is available at the following website: http://bbp.dau.mil/.

70 This section was authored by Robert Nichols, Partner, Jade C. Totman, Associate, and Christine Minarich, Associate, of Covington & Burling LLP.

71 Unless otherwise specified, the term "U.S. Contractor" can refer to any "U.S. person," as defined under 22 C.F.R. § 120.15:

> *U.S. person* means a person (as defined in § 120.14 of this part) who is a lawful permanent resident as defined by 8 U.S.C. 1101(a)(2)) or who is a protected individual as defined by 8 U.S.C. 1324b(a)(3). It also means any corporation, business association, partnership, society, trust, or any other entity, organization or group that is incorporated to do business in the United States. It also includes any governmental (federal, state or local) entity. It does not include any foreign person as defined in § 120.16 of this part.

72 As discussed in the first half of this paper, FMS can be used by a foreign country or international organization, not by a private company or similar entity. But in this half of the paper, as used for the purpose of describing DCS, the term "Non-U.S. Purchaser" can refer to any "foreign person," as defined under 22 C.F.R. § 180.16:

> *Foreign person* means any natural person who is not a lawful permanent resident as defined by 8 U.S.C. 1101(a)(20) or who is not a protected individual as defined by 8 U.S.C. 1324b(a)(3). It also means any foreign corporation, business association, partnership, trust, society or any other entity or group that is not incorporated or organized to do business in the United States, as well as international organizations, foreign governments and any agency or subdivision of foreign governments (*e.g.*, diplomatic missions).

[73] U.S. GOVERNMENT ACCOUNTABILITY OFFICE ("**GAO**") REPORT TO THE COMMITTEE ON FOREIGN AFFAIRS, HOUSE OF REPRESENTATIVES, *DEFENSE EXPORTS: REPORTING ON EXPORTED ARTICLES AND SERVICES NEEDS TO BE IMPROVED*, GAO-10-952 (Sept. 2010) ("**GAO-10-952 Report**"), at 1.

[74] FOREIGN MILITARY SALES, "FREQUENTLY ASKED QUESTIONS," http://www.dsca.mil/sites/default/files/fms_faq2_0.pdf (last visited March 13, 2014) (noting that the official U.S. policy is "neutral" as to "whether countries purchase U.S. defense articles or services commercially or through FMS"). Formerly, the official U.S. policy was to limit the use of FMS to specified situations, and to actively encourage DCS. *See* Garry S. Grossman, *Foreign Military Sales*, 87-12 Briefing Papers 1, 6 (Nov. 1987) (citation omitted).

[75] This article is not intended to create an attorney-client relationship. DCS's considerable complexity cannot be unwound in just one article, and specific concerns or questions should be referred to experienced counsel.

[76] U.S. DEFENSE INSTITUTE OF SECURITY ASSISTANCE MANAGEMENT ("**DISAM**"), *THE MANAGEMENT OF SECURITY COOPERATION* (32d ed. Jan. 2013)) ("**DISAM MANUAL**"), at 15-3 (citing DSCA Policy Memorandum 09-32, "Responses to Industry Requests for FMS Support Relating to DCS").

[77] *See* DSCA website, available at http://www.dsca.mil/resources/foreign-military-financing-direct-commercial-contracts-fmf-dcc.

[78] DISAM MANUAL at 15-4 ("[A]ll FMFP financed purchases must be approved by DSCA on a contract-by-contract basis using *Guidelines for Foreign Military Financing of Direct Commercial Contracts* and the contractor certification provided at http://www.dsca.mil.").

[79] Similarly, defense services to be purchased via DCC must be performed by U.S. manufacturers and suppliers.

[80] *See* DSCA Guidelines for Foreign Military Financing of Direct Commercial Contracts, August 2009. On the one hand, an important exception to this general rule is that FMF may be considered for non-U.S. content if it is an integral part of a commercially available off-the-shelf ("**COTS**") item. A COTS item may be eligible for FMF if it is manufactured and assembled in the United States by a U.S. manufacturer or supplier and is composed of at least 51% U.S. origin content. To approve the use of this exception, the DSCA requires a detailed description of the COTS item, to include information about sales of the COTS item in the commercial marketplace. On the other hand, computation of U.S. content can become even more complex when accounting for intellectual property, content provided by foreign subsidiaries and subcontractors, and sources of compensation of the workforce.

[81] DISAM MANUAL at 15-14.

[82] *See* SAMM C6.3.9. regarding offsets. As noted above, however, a DCS contract funded by FMF "cannot include an offset agreement." U.S. offset policy is contained in Sec. 123 of the Defense Production Act Amendments of 1992 (P.L. 102-558) , which

provides: “no agency of the United States Government shall encourage, enter directly into, or commit United States firms to any offset arrangement in connection with the sale of defense goods or services to foreign governments” and “the decision whether to engage in offsets, and the responsibility for negotiating and implementing offset arrangements, reside with the companies involved.”

[83] *See* SAMM C4.3.11., C11.5., section 30 of the AECA (22 U.S.C. 2770), and DISAM Manual at 15-5.

[84] DISAM Manual at 15-7.

[85] *Id.*

[86] *Id.*

[87] The flexibility inherent in DCS explains why some U.S. Contractors and Non-U.S. Purchasers might be drawn to DCS, not to FMS (*e.g.*, a Non-U.S. Purchaser comfortable negotiating with a U.S. Contractor may see DCS as providing negotiating opportunities). Or *vice versa*, where the a party does not desire this flexibility (*e.g.*, a U.S. Contractor may not want to subject itself to foreign law, or a Non-U.S. Purchaser may prefer the security afforded by FMS).

[88] *Id.* at 15-6, 15-14.

[89] *Id.* at 15-7.

[90] *Id.* at 15-15.

[91] *Id.* at 15-5. *See also*, section 1of the AECA (22 U.S.C. § 2751).

[92] Other agencies may exercise jurisdiction, as well, including the U.S. Department of Energy and the U.S. Department of the Treasury, Office of Foreign Assets Control.

[93] Technical data includes: (1) information, other than software required for the design, development, production, manufacture, assembly, operation, repair, testing, maintenance or modification of defense articles, including information in the form of blueprints, drawings, photographs, plans, instructions, or documentation; (2) classified information relating to defense articles and defense services on the USML and 600-series items controlled by the Commerce Control List; (3) information covered by an invention secrecy order; and (4) software directly related to defense articles. *See* ITAR § 120.10.

[94] 22 C.F.R. Parts 120-130.

[95] These embargoed or “proscribed” countries currently are Afghanistan, Belarus, Burma, China, Cote d’Ivoire, Cuba, Cyprus, the Democratic Republic of the Congo, Eritrea, Fiji, Guinea, Haiti, Iran, Iraq, Lebanon, Liberia, Libya, North Korea, Somalia, Sri Lanka, the Republic of Sudan (but not the Republic of South Sudan), Syria, Venezuela, Vietnam, and Zimbabwe.

[96] 15 C.F.R. Parts 730-775.

[97] These regulations include those set forth in 31 C.F.R. Parts 500-598.

[98] The U.S. Government’s consolidated screening list is available at http://export.gov/ecr/eg_main_023148.asp.

[99] On a quarterly basis, the Treasury Department publishes a list of countries participating in this boycott of Israel. The most recent list includes: Iraq, Kuwait, Lebanon, Libya, Qatar, Saudi Arabia, Syria, United Arab Emirates, and Yemen.

[100] *See* 15 C.F.R. Part 760.

[101] *See* Internal Revenue Code, Section 999.

[102] Covering all of the complex prohibitions and penalties in the U.S. anti-boycott laws is beyond the scope of this paper. In general, though, the following activities could raise anti-boycott issues: refusing or agreeing to refuse to do business with or in a boycotted country or with its government, nationals, or companies; refusing or agreeing to refuse to do business with a boycotted/blacklisted person, insurer, or vessel; agreeing to refuse to do business with a company whose ownership or management is made up of individuals of a particular nationality, race, or religion; furnishing or agreeing to furnish information concerning the business relationships of the company, or its parent or affiliate companies, with Israel, companies, residents, or nationals of Israel, or with regard to any person or company on a blacklist; furnishing information, in deference to a boycott requirement or request, about the race, religion, sex, nationality, or national origin of a U.S. person; and refusing or agreeing to refuse to hire or otherwise discriminating against a U.S. person, in deference to a boycott requirement or request, on the basis of that person's race, religion, sex, nationality, or national origin.

[103] 14 U.S.C. §§ 78m, 78dd-1, 78dd-2, 78dd-3, 78ff. The FCPA is the most pressing anti-corruption law wielded by the U.S. Government. Other relevant laws have been passed by the U.S. Government—such as those that address wire and mail fraud, accounting and certifications, and taxes and securities—and might apply to a DCS transaction, but they are beyond the scope of this paper.

[104] For all that, there are a few narrow, case-by-case exceptions and defenses to FCPA liability. "Grease payments"—*i.e.*, payments to expedite or facilitate the performance of a routine action—might not violate the FCPA's anti-bribery provisions. That said, they still must comply with foreign laws and the FCPA's bookkeeping provisions. Also, a person accused of violating the FCPA can attempt to show that a payment was legal under foreign law, or that a payment was a reasonable, bona fide expense directly related to promoting a product or performing a contract.

[105] Still, where an issuer holds less than a majority interest, it must only exercise good faith efforts towards promoting the use of proper accounting controls and practices by the subsidiary or affiliate.

[106] An individual that violates the anti-bribery provisions faces a civil fine of up to $10,000 and a criminal penalty of up to $250,000, plus five years' imprisonment, per violation.

[107] An individual that violates the bookkeeping and accounting provisions faces a civil penalty of up to $100,000 and a criminal fine of up to $5 million, plus twenty years' imprisonment, per violation.

[108] 18 U.S.C. §§ 1956-57. Among the other criminal money laundering statutes enforced by the U.S. Government, the Travel Act, 18 U.S.C. § 1952, prohibits interstate or

foreign travel that is conducted with the intent to distribute any proceeds of certain illegal conduct, or to promote or carry on any such conduct. Offenses are punishable by five years' imprisonment.

[109] *See generally* FAR Subpart 9.4 (procurement); 2 C.F.R. Part 180 (nonprocurement).

[110] *See* 22 C.F.R. § 127.7 (identifying bases for statutory and discretionary debarment by U.S. Department of State such that the agency "may prohibit any person from participating directly or indirectly in the export, reexport and retransfer of defense articles, including technical data, or in the furnishing of defense service"); 22 C.F.R. § 127.8 (identifying bases for interim suspension of "any person" by U.S. Department of State); *see also* 2 C.F.R. Part 1326 (implementing suspension and debarment procedures for Department of Commerce).

[111] *See, e.g.*, 22 C.F.R. § 126.7(a)(5) (allowing U.S. Department of State to deny, revoke, suspend, or amend a license when "[a]n applicant is ineligible to contract with, or to receive a license or other authorization to import defense articles or defense services from, any agency of the U.S. Government").

[112] *Id.* § 126.7(a)(6).

[113] *Id.* § 127.1(d).

[114] Bribery Act, 2010 (UK).

[115] For one thing, the Bribery Act does not contain an exception for grease payments.

[116] A "commercial organization" is an entity incorporated under the law of any part of the UK which carries on business in the UK or elsewhere; a UK partnership which carries on business in the UK or elsewhere; or any other corporate body or partnership incorporated or formed under any foreign jurisdiction, but which carries on business in any part of the UK.

[117] Because the UK Bribery Act prohibits bribes of "another person," it can have broader application than the FCPA, which prohibits bribes of a foreign official.

[118] A "foreign public official" is any elected or unelected individual holding a legislative, administrative, or judicial position outside of the UK; any individual who exercises a public function for a country, territory, public agency, or public enterprise outside of the UK; or any individual who is an official or agent of a public international organization.

[119] This is a strict liability offence, subject to a defense that the organization had adequate procedures in place that were designed to prevent bribery.

[120] *See* 15 C.F.R. Part 701. The Department of Commerce recently published a notice reminding U.S. Contractors of this reporting obligation. *See* 79 Fed. Reg. 18,886, 18,887 (Apr. 4, 2014). U.S. Contractors also must annually report information on offset transactions completed in performance of existing offsets commitments for which offsets credits of $250,000 or more have been claimed from a foreign representative. *Id.*

[121] In alphabetical order, the forty-two GPA signatories are: Armenia; Canada; the European Union's twenty-eight member states (Austria, Belgium, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Hungary, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxemburg, Malta, Netherlands, Poland, Portugal, Romania, Slovak Republic, Slovenia, Spain, Sweden, and the UK); Hong Kong, China; Iceland; Israel; Japan; Korea; Liechtenstein; the Netherlands with respect to Aruba; Norway; Singapore; Switzerland; Chinese Taipei, and the United States.

[122] The OECD's thirty-four member countries have adopted the Convention: Australia; Austria; Belgium; Canada; Chile; Czech Republic; Denmark; Estonia; Finland; France; Germany; Greece; Hungary; Iceland; Ireland; Israel; Italy; Japan; Korea; Luxembourg; Mexico; Netherlands; New Zealand; Norway; Poland; Portugal; Slovak Republic; Slovenia; Spain; Sweden; Switzerland; Turkey; the UK; and the United States. So too have six non-members: Argentina; Brazil; Bulgaria; Colombia; Russia; and South Africa. A forty-first country, Latvia, is in the process of acceding to the Convention.

[123] *See* Transparency International Report, *Exporting Corruption? Country Enforcement of the OECD Anti-Bribery Convention, Progress Report 2012* (2d ed. 2012) http://issuu.com/transparencyinternational/docs/2012_exportingcorruption_oecdprogress_en?e=2496456/2042485.

[124] Consider as well the United Nations ("**UN**") Arms Trade Treaty ("**ATT**"), adopted by the UN General Assembly on April 2, 2013. A multilateral treaty, the ATT is meant to regulate the international export, import, transit, trans-shipment and/or brokering of conventional weapons, including battle tanks, armored combat vehicles, large-caliber artillery systems, combat aircraft, attack helicopters, warships, missiles and missile launchers, and small arms and light weapons. It will enter into force after it has been ratified by 50 states; to now, though, only 32 states have ratified it. It was signed (but is not yet ratified) by the United States on September 25, 2013.

[125] Other international procurement and anti-corruption agreements are overseen by the UN, including the UN Convention on Corruption and the UN Declaration Against Corruption and Bribery in International Commercial Transactions; the Council of Europe ("**COE**"), including the COE Civil and Criminal Law Conventions on Corruption, the COE Model Code of Conduct for Public Officials, and the COE Convention on the Fight Against Corruption Involving Officials of the European Communities or Officials of Member States of the European Union; the Organization for American States ("**OAS**"), including the OAS Inter-American Convention Against Corruption; and the African Union ("**AU**"), including the AU Convention on Preventing and Combating Corruption.

[126] SAMM C4.3.5, C4.3.5.2. and section 2 of the AECA (22 U.S.C. 2752).

[127] SAMM C4.3.5.3. and DISAM Manual at 15-2.

[128] SAMM C4.3.6., C4.3.6.1., C4.3.6.2., and C4.3.6.3.

[129] SAMM, C4.3.7., C4.3.7.1., C4.3.7.2, and DISAM MANUAL at 15-4.

[130] DISAM Manual at 15-1.

[131] "Total Package Approach" is defined as: "A means of ensuring that FMS customers are aware of and are given the opportunity to plan for and obtain needed support items, training, and services from the U.S. Government contractors, or from within the foreign country's resources which are required to introduce and operationally sustain major items of equipment or systems." Glossary, SAMM, DSCA Manual 5105.38-M, available at http://www.samm.dsca.mil/listing/esamm-glossary.

[132] *See* DISAM Manual at 15-17; *see also* Catherine M. Cortes, *Direct Commercial and Foreign Military Sales, Chemical Defense Equipment: An Introductory Brochure* (June 1991), at 6.